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No. 98-1612

In the Supreme Court of the United States

DIAMOND MULTIMEDIA SYSTEMS, INC., WILLIAM J. SCHROEDER, GARY B. FILLER, and HYUNG HWE HUH,
Petitioners,

v.

SUPERIOR COURT OF SANTA CLARA COUNTY (*PASS*),
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF *AMICI CURIAE* OF WASHINGTON LEGAL FOUNDATION and ALLIED EDUCATIONAL FOUNDATION IN SUPPORT OF PETITIONERS

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QUESTIONS PRESENTED

1. Whether Section 25400 of the California Corporations Code violates the Commerce Clause of the U.S. Constitution by imposing securities fraud liability on persons who make or disseminate statements in California, where the securities purchaser, the securities seller and the securities transaction all are outside California, thereby allowing California directly to regulate securities transactions in other states and to impose burdens on interstate commerce that are excessive in relation to the local interests served by the statute.

2. Whether Section 25400 of the California Corporations Code, which conflicts with provisions of the federal Private Securities Litigation Reform Act of 1995 and undermines the purposes of Congress in enacting the Reform Act, is therefore impliedly preempted.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
INTEREST OF *AMICI CURIAE*	1
STATEMENT	2
SUMMARY OF ARGUMENT	6
REASONS FOR GRANTING THE WRIT	7
THE CALIFORNIA SUPREME COURT HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW IN A WAY THAT CONFLICTS WITH DECISIONS OF THIS COURT UNDER THE COMMERCE CLAUSE	7
A. The California Supreme Court's Decision Conflicts with the Court's Decisions Interpreting the Commerce Clause	7
1. This Court's decisions establish that no state may directly regulate inter-state commerce	7
2. The California Supreme Court's decision presents a genuine conflict with this Court's decisions prohibiting states from directly regulating interstate commerce	10
B. The California Supreme Court's Decision Is Sufficiently Important to Warrant this Court's Review	13
CONCLUSION	15

TABLE OF AUTHORITIES

Page

Cases:

Baldwin v. *G. A. F. Seelig, Inc.*, 294 U.S. 511 (1935) 9
BMW of North America, Inc. v. *Gore*, 517 U.S. 559 (1996) 1
Brown-Forman Distillers Corp. v. *New York State Liquor Authority*, 476 U.S. 573 (1986) 9
Camps Newfound/Owatonna, Inc. v. *Town of Harrison*, 117 S. Ct. 1590 (1997) 8
Cooley v. *Board of Wardens*, 53 U.S. (12 How.) 299 (1851) 7, 8
Edgar v. *MITE Corp.*, 457 U.S. 624 (1982) 9–11, 12
Freeman v. *Hewit*, 329 U.S. 249 (1946) 8
Healy v. *Beer Institute*, 491 U.S. 324 (1989) 9, 11, 12
Itel Containers Int'l Corp. v. *Huddleston*, 507 U.S. 60 (1993) 8
Lemke v. *Farmers Grain Co.*, 258 U.S. 50 (1922) 9
Limbach v. *Hooven & Allison Co.*, 466 U.S. 353 (1984) 7
Matsushita Elec. Indus. Co., Ltd. v. *Epstein*, 516 U.S. 367 (1996) 1
New York Life Ins. Co. v. *Head*, 234 U.S. 149 (1914) 14
Phillips Petroleum Co. v. *Shutts*, 472 U.S. 797 (1985) 12–13
Plaut v. *Spendthrift Farm, Inc.*, 514 U.S. 211 (1995) 1
Southern Pac. Co. v. *State of Ariz. ex rel. Sullivan*, 325 U.S. 761 (1945) 9
Tyler Pipe Indus. v. *Washington State Dep't of Revenue*, 483 U.S. 232 (1987) 8
Tyson Foods, Inc. v. *McReynolds*, 865 F.2d 99 (6th Cir. 1989) 9, 13
United States v. *Lopez*, 514 U.S. 549 (1995) 8

Constitutional Provisions, Statutes, and Rules:

CAL. CORP. CODE § 25400 ..... *passim*
CAL. CORP. CODE § 25500 ..... *passim*
Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 14

TABLE OF AUTHORITIES—Continued

	Page
Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. §§ 77p and 78bb	14
SUP. CT. R. 10(c)	7
U.S. CONST. art. I, § 8, cl. 3 (Commerce Clause)	*passim*
Williams Act, 15 U.S.C. §§ 78m(d)–(e) and 78n(d)–(f)	10
Other Materials:	
DAVID P. CURRIE, THE CONSTITUTION IN THE SUPREME COURT: THE FIRST HUNDRED YEARS 1789–1888 (1985)	7–8
Diamond Multimedia 1998 Annual Report (http://www.diamondmm.com/company/index.html)	2
Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273 (1998)	14
ROBERT L. STERN, ET AL., SUPREME COURT PRACTICE (7th ed. 1993)	7

INTEREST OF *AMICI CURIAE*

The Washington Legal Foundation (WLF) is a nonprofit public interest law and policy center based in Washington, D.C., with supporters in all 50 States. WLF regularly appears in legal proceedings before federal and state courts to defend and promote free enterprise and individual rights.

WLF has appeared before this Court in cases involving the interpretation and application of federal securities laws. *See Matsushita Elec. Indus. Co., Ltd.* v. *Epstein*, 516 U.S. 367 (1996); *Plaut* v. *Spendthrift Farm, Inc.*, 514 U.S. 211 (1995). WLF has also appeared before this Court in cases regarding tort reform. *BMW of North America, Inc.* v. *Gore*, 517 U.S. 559 (1996).

The Allied Educational Foundation (AEF) is a nonprofit charitable and educational foundation based in Englewood, New Jersey. Founded in 1964, AEF is dedicated to promoting education in diverse areas of study, such as law and public policy, and has appeared as *amicus curiae* in this Court on several occasions.

WLF and AEF are filing this brief because of their ongoing interest in controlling the abuse of nationwide class actions as a tool of securities litigation. For these reasons, *amici* submit this brief to assist the Court in determining whether to grant review.[1]

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than the *amici curiae*, contributed monetarily to the preparation and submission of this brief. The parties have consented to the filing of this brief, and letters indicating their consent have been filed with the Clerk of the Court.

STATEMENT

In the interest of judicial economy, WLF incorporates by reference the factual statement as it appears in the opinion of the California Supreme Court. Pet. A-1–A-58. In addition, however, we wish to emphasize certain aspects of the record.

Petitioners Diamond Multimedia Systems, Inc. and its corporate officers (Diamond Multimedia) design and produce graphics, multimedia, and modem products for personal computers. *See Diamond Multimedia 1998 Annual Report*, at 7 (http://www.diamondmm.com/company/index.html). Incorporated in Delaware, *see id.*, its principal place of business lies in San Jose, California. *See id.* Diamond Multimedia shares are traded nationally on the National Association of Security Dealers Quotation (NASDAQ) System. Pet. App. A-4 and A-4 n.6.

Between April 13, 1995 and December 1995, Diamond Multimedia stock prices rose from just under $20 per share to more than $40 per share. *Id.* In November 1995, Diamond Multimedia held a public offering where it sold 3.15 million shares and its officers sold 315,041 shares for about $30 per share. *Id.* at A-4–A-5. These same officers sold 226,672 shares from January through March 1996. *See id.* at A-5. And in April and May 1996, they sold additional shares for $136,250. *Id.* at A-5. By May 1996, the price of Diamond Multimedia stock had dropped to $20 per share, *id.*, and it tumbled even further following an announcement on June 20, 1996 that the corporation would suffer a loss and would write down its inventory. *Id.*

These changes in the price of Diamond Multimedia stock sparked this litigation. Respondent Joanna Pass

(Pass) filed suit against Diamond Multimedia and its corporate officers in the Superior Court of Santa Clara County, California on behalf of herself and any purchaser of Diamond Multimedia common stock between October 26, 1995 and June 20, 1996.[2] *Id.* at A-3. Pass's complaint alleged that Diamond Multimedia's corporate officers knew of negative private information concerning Diamond Multimedia's products and financial condition. *Id.* The complaint also alleged that the officers knew of and approved "false statements issued by or on behalf of Diamond Multimedia during the class period," *id.*, including filing documents with the Securities and Exchange Commission (SEC) that contained "overstated assets, and omitted information about significant problems with Diamond Multimedia products . . . ." *Id.* at A-3–A-4 n.5.

Pass brought her claims under two sections of the California Corporations Code.

Section 25400 provides in relevant part:

> It is unlawful for any person, directly or indirectly, *in this state*:
>
> (d) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the

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[2] On October 2, 1996, Pass's attorneys, representing a different named plaintiff but the same nationwide class, filed a parallel federal class action in the U.S. District Court for the Northern District of California. *See* Pet. 2. That action is irrelevant for purposes of the Questions Presented, which arise from the decision of the California Supreme Court.

> circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading.

CAL. CORP. CODE § 25400 (emphasis added). Section 25500, which offers a civil remedy for injuries caused by conduct proscribed under Section 25400, provides:

> Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. . . .

Id. at § 25500.

Diamond Multimedia demurred, arguing that the complaint "failed to plead the jurisdictional prerequisite," Pet. A-7, by neglecting to allege that any challenged stock transaction had occurred "in this state." *Id.* The Superior Court overruled this demurrer. "It ruled that plaintiffs had adequately alleged that the defendants made misstatements for the purpose of inducing purchase of Diamond Multimedia stock . . . ." *Id.* at A-8.

Diamond Multimedia then petitioned the California Court of Appeal for a writ of mandate,[3] which the

[3] As the California Supreme Court has explained, "The petition for a writ of mandamus seeks a peremptory writ directing the (continued...)

court denied. *Id.* at A-59. The California Supreme Court granted review, however, addressing "whether that civil remedy [contained in Section 25500] is available to out-of-state purchasers who bought or sold a stock whose price was affected by stock manipulation if the purchase or sale took place outside the State of California." *Id.* at A-2.

In a divided opinion the court held that the words "in this state" contained in Section 25400 place no jurisdictional limit on the claimants who may raise a claim under Section 25500. "[O]ut-of-state purchasers and sellers of securities whose price has been affected by the unlawful market manipulation proscribed by section 24500 may avail themselves of the remedy afforded by section 25500. The remedy is not limited to transactions made in California." *Id.* at A-44.

The majority reached this surprising conclusion in two stages. First, it distinguished between regulating securities transactions and regulating manipulations of the securities market. Section 25400, the court said, "regulates market manipulation, not third party transactions affected by market manipulation." *Id.* at A-14. Second, the court expressly refused "to confine liability for violation of section 25400 to intrastate transactions." *Id.* at A-20. Instead it defined the key language from Section 25400, "in this state," to refer to any "statement . . . made by a person in California or . . . willfully disseminated in California." *Id.* at A-21. As the court acknowledged, this interpretation makes the remedy offered by

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[3] (...continued)
superior court to vacate the order overruling Diamond Multimedia's demurrer to the Corporate Securities Law cause of action and to enter a new order sustaining that demurrer." Pet. A-8.

Section 25500 "available without any express territorial limitation." *Id.* at A-15.

Following the decision of the California Supreme Court, Diamond Multimedia filed a petition for writ of certiorari with this Court.

SUMMARY OF ARGUMENT

The California Supreme Court has decided that California law regulates the securities market for the entire nation. This decision plainly conflicts with several of the Court's decisions, which establish that state statutes violate the Commerce Clause when they directly regulate interstate commerce. What's more, the lower court has unfairly imposed California law as the rule of decision in a nationwide class action, where many unnamed class members have little if any connection with California.

The Questions Presented are sufficiently important to warrant this Court's review. The California Supreme Court's decision, which purports to extend that state's jurisdiction over the nation's securities market, touches on the conduct of nationwide securities class actions and the authority of any state to regulate interstate commerce. Moreover, the importance of the case is bolstered by the role of securities in our national economy and of maintaining the proper division of authority between the national government and the states. Even the court below admitted that the strategic flight of securities class action suits to state courts makes a decision setting California's jurisdictional limits "increasingly important to shareholders, corporations, and the judicial system." Pet. A-12.

REASONS FOR GRANTING THE PETITION

THE CALIFORNIA SUPREME COURT HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW IN A WAY THAT CONFLICTS WITH DECISIONS OF THIS COURT UNDER THE COMMERCE CLAUSE

Under this Court's rules, one reason for granting certiorari occurs when "a state court . . . has decided an important federal question in a way that conflicts with relevant decisions of this Court." SUP. CT. R. 10(c). As distinguished scholars of this Court's certiorari jurisprudence have observed, "A conflict between a decision of the highest state court and that of the Supreme Court on a matter of federal law is a strong reason for the granting of certiorari." ROBERT L. STERN, ET AL., SUPREME COURT PRACTICE 208 (7th ed. 1993); *see also Limbach* v. *Hooven & Allison Co.*, 466 U.S. 353, 362 (1984) ("We are concerned with federal issues and a contention that a state court disregarded a federal constitutional ruling of this Court."). *Id.* This case presents such a conflict.

A. The California Supreme Court's Decision Conflicts with the Court's Decisions Interpreting the Commerce Clause

1. This Court's decisions establish that no state may directly regulate interstate commerce

Early in its history the Court recognized that Congress's authority "[t]o regulate commerce . . . among the several States," U.S. CONST. art. I, § 8, cl. 3, has a negative aspect. *Cooley* v. *Board of Wardens*, 53 U.S. (12 How.) 299, 318–19 (1851); *see also* DAVID P. CURRIE, THE CONSTITUTION IN THE SUPREME COURT: THE FIRST HUNDRED YEARS 1789–1888, at 236

(1985) ("*Cooley*'s dictum finally established that the commerce clause sometimes limited state power). This negative or "dormant" Commerce Clause operates "even without implementing legislation by Congress [as] a limitation upon the power of the States." *Freeman* v. *Hewit*, 329 U.S. 249, 252 (1946).

Although "there is widespread acceptance of [the Court's] authority to enforce the dormant Commerce Clause," *United States* v. *Lopez*, 514 U.S. 549, 579 (1995) (Kennedy, J., concurring), some members of the Court have expressed skepticism, if not outright hostility, toward such claims. *See Camps Newfound/Owatonna, Inc.* v. *Town of Harrison*, 117 S. Ct. 1590, 1615 (1997) (Thomas, J., dissenting) ("The negative Commerce Clause has no basis in the text of the Constitution, makes little sense, and has proved virtually unworkable in application."); *Tyler Pipe Indus.* v. *Washington State Dep't of Revenue*, 483 U.S. 232, 263 (Scalia, J., concurring in part and dissenting in part) ("The historical record provides no grounds for reading the Commerce Clause to be other than what it says—an authorization for Congress to regulate commerce."). Nonetheless, even the most skeptical of members has agreed to "enforce on stare decisis grounds a 'negative' self-executing Commerce Clause . . . against a state law that is indistinguishable from a type of law previously held unconstitutional by this Court." *Itel Containers Int'l Corp.* v. *Huddleston*, 507 U.S. 60, 78 (1993) (Scalia, J., concurring in part and concurring in judgment).

A strong and consistent line of this Court's precedent has established the principle that "a statute that directly controls commerce occurring wholly outside the boundaries of a State exceeds the inherent limits of the enacting State's authority and is invalid regardless of whether the statute's extraterritorial

reach was intended by the legislature." *Healy* v. *Beer Inst.*, 491 U.S. 324, 336 (1989); *see also Tyson Foods, Inc.* v. *McReynolds*, 865 F.2d 99, 102 (6th Cir. 1989) ("Under the Commerce Clause, one state simply cannot regulate the commercial activity of the citizens of the other forty-nine states."). This principle "reflect[s] the Constitution's special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and with the autonomy of the individual States within their respective spheres." *Healy*, 491 at 335–36. "The critical inquiry is whether the practical effect of the regulation is to control conduct beyond the boundaries of the State." *Id.* at 336 (citing *Brown-Forman Distillers Corp.* v. *New York State Liquor Auth.*, 476 U.S. 573, 579 (1986)).

Edgar v. MITE Corp., 457 U.S. 624 (1982) aptly illustrates how the Court has applied this per se rule of "no direct regulation."[4] At issue there was whether an Illinois anti-takeover statute impermissibly

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[4] In addition to *MITE*, the Court has consistently struck down state legislation based on the "no direct regulation" rule in a variety of cases over a fairly long stretch of time. *See, e.g.*, Lemke v. Farmers Grain Co., 258 U.S. 50, 61 (1922) (invalidating North Dakota law requiring exported wheat to be sold outside of North Dakota at price set by North Dakota state inspector); Baldwin v. G. A. F. Seelig, Inc., 294 U.S. 511, 521 (1935) (invalidating New York law that banned the importation of milk into New York when the price paid outside of New York to the out-of-state producer was lower than that permitted under then-existing laws regulating milk purchases from New York producers); Southern Pac. Co. v. State of Ariz. ex rel. Sullivan, 325 U.S. 761, 781–82 (1945) (invalidating Arizona law that prescribed the length of trains that could operate in Arizona); Brown-Forman Distillers Corp. v. New York State Liquor Auth., 476 U.S. 573, 579 (1986) (invalidating New York law requiring liquor importers to affirm that prices offered to New York wholesalers were the lowest nationwide); Healy v. Beer Institute, 491 U.S. 324, 337 (1989) (invalidating Connecticut law prohibiting beer imports unless seller guaranteed that prices offered in Connecticut were no higher than in neighboring states).

conflicted with the Williams Act, 15 U.S.C. §§ 78m(d)–(e) and 78n(d)–(f), and the Commerce Clause. The Illinois statute required that a tender offeror notify the Secretary of State and the target company of its intent to make a tender offer and its terms prior to the effective date of the offer.

The Court began with the premise that "[t]he Commerce Clause . . . permits only *incidental* regulation of interstate commerce by the States; direct regulation is prohibited." *MITE Corp*, 457 U.S. at 640 (citations omitted) (emphasis in original). It observed that state blue-sky laws had been regularly sustained against Commerce Clause challenges because "they only regulated transactions occurring within the regulating States." *Id.* In contrast, the Illinois statute at issue in *MITE* directly regulated transactions which took place "across state lines, even if wholly outside [the state]." *Id.* Because the Illinois law "directly regulates and prevents, unless its terms are satisfied, interstate tender offers which in turn would generate interstate transactions," *Id.* at 640, the Court found that it violated the Commerce Clause.

2. The California Supreme Court's decision presents a genuine conflict with this Court's decisions prohibiting states from directly regulating interstate commerce

The decision of the California Supreme Court squarely conflicts with *MITE Corp.* and numerous related decisions that forbid any state to directly regulate interstate commerce.

The court's interpretation of Section 25400 extends California's reach far beyond its legitimate grasp:

> Section 25400 . . . does not regulate third party securities transactions. Its focus is the prevention of manipulation of the market price of securities. The only transactions section 25400 regulates are manipulative transactions in California. The price of most stock is established on a national market. For that reason section 25400 is not concerned with whether the third party sale or purchase of stock affected by such manipulation takes place in California and does not limit the right to recover for damage caused by market manipulation to persons who buy or sell stock in California.

To begin with, the Court acknowledges that its interpretation of Section 25400 has the effect of regulating interstate transactions. The court relied on the fact that "[t]he price of most stock is established on a national market," *id.*, to justify its conclusion that a right of action under Section 25500 is not limited to "persons who buy or sell stock in California." *Id.* But this is just another way of saying that a State is justified in regulating interstate commerce because interstate commerce affects that State's economy. If adopted, such a proposition would dissolve the distinction between intra- and interstate commerce altogether and with it the boundaries on a state's authority to regulate interstate commerce.

Thus, the lower court's decision has the practical effect of allowing the State of California to directly regulate interstate securities transactions. *See Healy* v. *Beer Inst.*, 491 U.S. 324, 336 (1989). Under the court's reading of Section 25500, a New York investor who buys 10 shares of a Delaware corporation can find himself embroiled in lawsuit brought in California court over whether a corporate officer made materially

false statements regarding the corporation's financial performance during a news interview conducted in Washington, D.C. So long as the statements are "willfully disseminated in California," Pet. App. A-21, which a claimant can presumably demonstrate by producing a nationally distributed news report, the court would permit that suit to be filed in California. The California Supreme Court's decision thus unavoidably conflicts with the Court's oft-repeated rule that "a statute that directly controls commerce occurring wholly outside the boundaries of a State exceeds the inherent authority and is invalid regardless of whether the statute's extraterritorial reach was intended by the legislature." *Healy v. Beer Institute*, 491 U.S. 324, 336 (1989). If Illinois may not regulate out-of-state tender offers, *see MITE*, 457 U.S. at 641–42, and if Connecticut may not require out-of-state beer distributors to affirm that they have charged Connecticut wholesalers no more than they have charged wholesalers in neighboring states, *see Healy*, 491 U.S. at 339–40, then it is equally impermissible for California to impose liability on issuers for statements made out-of-state and on which only non-Californians rely.

This new-found extraterritorial reach of Section 25500 raises a closely related constitutional problem. By imposing California law to resolve a dispute including parties from around the country, most with no discernible contacts with California, the lower court ignored the unfairness of adopting its own law to resolve such nationwide class actions. In *Phillips Petroleum Co.* v. *Shutts*, 472 U.S. 797 (1985), the Court addressed whether Kansas violated the Fourteenth Amendment Due Process Clause and the Full Faith and Credit Clause when it applied its own law to resolve lease disputes where "over 99% of the gas leases and some 97% of the plaintiffs in the case had

no apparent connection to the State of Kansas except for this lawsuit." *Id.* at 815. The Court first noted that "[w]hen considering fairness in this context, an important element is the expectation of the parties." *Id.* at 822. In *Shutts*, the Court found "no indication that when the leases involving land and royalty owners outside of Kansas were executed, the parties had any idea that Kansas law would control." *Id.* On this basis, the Court reversed the Kansas Supreme Court's decision to apply its own law. *See id.* at 823.

The California Supreme Court's decision harbors the same constitutional difficulties that the Court discerned in *Shutts*. Interpreting California law to invite nationwide securities lawsuits, without regard to the presence or absence of jurisdictional ties between the State and the parties, and without regard to the choice-of-law expectations of the parties, contradicts the Court's decision in *Shutts*. As the Court there emphasized, "constitutional limitations . . . must be respected even in a nationwide class action." *Id.* at 823.

B. The California Supreme Court's Decision Is Sufficiently Important to Warrant this Court's Review

Aside from evident importance of the conflict we have described, other factors establish that the decision below merits this Court's review.

First, a fair evaluation of the importance of the Questions Presented must start by acknowledging that "there is no greater national activity than the interstate financial markets of the United States." *Tyson Foods, Inc. v. McReynolds*, 865 F.2d 99, 102 (6th Cir. 1989). The lower court's decision purports to extend state court jurisdiction over the securities

market of the entire nation. Whether any state may legitimately exercise such jurisdiction is thus a question of large importance, considered strictly from an economic perspective.

Second, the California Supreme Court's decision has broad ramifications because it threatens to "throw[ ] down the constitutional barriers by which all the states are restricted within the orbits of their lawful authority, and upon the preservation of which the government under the Constitution depends." *New York Life Ins. Co.* v. *Head*, 234 U.S. 149, 161 (1914). If that decision stands uncorrected, a State will have arrogated the power to regulate a vital component of interstate commerce for the citizens of all 50 States.

Third, the importance of the Questions Presented is supported by the fact that Congress has enacted two major pieces of legislation in the past four years to remedy perceived abuses in federal securities litigation. *See* Private Securities Litigation Reform Act of 1995 (Reform Act), 15 U.S.C. § 78u-4; Securities Litigation Uniform Standards Act of 1998 (Uniform Standards Act), 15 U.S.C. §§ 77p and 78bb; *see also* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 308–09 (1998) (describing how claimants strategically avoided litigation restrictions contained in the Reform Act by bringing nationwide class actions in state courts).

CONCLUSION

For the foregoing reasons, *amici curiae* Washington Legal Foundation and Allied Educational Foundation urge the Court to grant the petition.

Respectfully submitted,

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